IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

In Re

FREEDOMLAND, INC.,

Bankrupt.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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William Otte, Trustee in Bankruptcy of Freedomland, Inc., prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Second Circuit rendered on June 8, 1973 affirming a judgment entered in the United States District Court, Southern District of New York which directed Petitioner to withhold taxes from wage claimants in connection with "priority" wage claim distributions made pursuant to 11 U.S.C. § 104 (a) (2), but reversing the judgment insofar as it provided that the withheld taxes be held subject to the fourth priority established under 11 U.S.C. § 104(a) (4), and directing that the taxes so withheld be held subject to the second priority established under 11 U.S.C. § 104(a) (2).

Opinion Below

The Opinion of the Court of Appeals is not yet reported.

Jurisdiction

The Decision of the Court of Appeals was rendered on June 8, 1973. The jurisdiction of this court is invoked under 28 U.S.C. § 1254.

Questions Presented For Review

1. Does a distribution in a bankruptcy proceeding pursuant to 11 U.S.C. § 104(a)(2) constitute "wages", payable by an "employer" to an "employee", which are subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code?

2. Assuming *arguendo* that such a distribution is subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the monies withheld in connection with the distribution be accorded fourth priority "tax claim" status pursuant to 11 U.S.C. § 104(a)(4), first priority "administration claim" status pursuant to 11 U.S.C. § 104(a)(1), second priority "wage claim" status pursuant to 11 U.S.C. § 104(a)(2), or "trust fund" status, or barred entirely as being the equivalent of a penalty?

3. Assuming *arguendo* that such a distribution is subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the claims of the United States and the City of New York have been barred because no proofs of claim for the withholding taxes in issue were filed by them in the Bankruptcy Court?

4. Is compliance with the withholding and reporting requirements of the Internal Revenue Code and the New York City Administrative Code in connection with such a distribution inconsistent with the spirit of economy of the Bankruptcy Act and therefore inapplicable in bankruptcy proceedings?

Statutes and Authorities Involved

Title 11, United States Code:

§ 93j

§93 n

§ 103(a)(8)

§ 104(a)(1)

§ 104(a)(2)

§ 104(a)(4)

Title 26, United States Code:

§ 3102(a)

§ 3401(a)

§ 3401(d)(1)

§ 6001

§ 6011(a)

§ 6041

Statement of the Case

Freedomland, Inc. ("Freedomland") filed a petition for an arrangement under Chapter XI of the Bankruptcy Act in the United States District Court, Southern District of New York on September 15, 1964. On August 30, 1965, it was adjudicated a bankrupt.

During the statutory filing period for filing claims, 413 claims of $600.00 or less were filed by Freedomland's former employees in its bankruptcy proceeding on account of wages that had been earned by the claimants *prior* to September 15, 1964, the date on which Freedomland filed its Chapter XI petition. No proofs of claim for withholding, social security, or related payroll taxes relative to

these claims were filed by the United States or the City of New York during the statutory filing period, after the expiration of that period, or pursuant to the "bar order" entered in the bankruptcy proceedings which directed all taxing authorities having claims against Freedomland, or petitioner, to file their claims with petitioner's attorney or be "forever barred from making any claim against Freedomland's estate or the Trustee" [Petitioner].

Freedomland's bankruptcy schedules indicated that it owed $80,000.00 on account of priority wage claims. However, the schedules omitted to set forth the names, addresses, social security numbers, number of dependents or related information concerning the claimants to whom such amount was admittedly due, although it is possible that such information existed in forty-two filing cabinets of Freedomland's records located at a warehouse.

On November 7, 1969, petitioner moved for and was granted authority to make a distribution to Freedomland's 413 priority wage claimants by paying the claims in full without any requirement to: (1) withhold Federal, State or City taxes, (2) pay such taxes to the taxing authorities, (3) file tax returns with the taxing authorities, (4) furnish withholding tax statements to the claimants, or (5) pay any penalties to the taxing authorities for failure to withhold and pay or file tax returns in connection with the distribution. Petitioner's motion was granted on the ground, *inter alia,* that the withholding/reporting requirements of the taxing authorities were inconsistent with the object of efficient, expeditious, and economical administration of bankrupt estates. Thereafter, on appeal to the District Court, and after an evidentiary hearing in which petitioner presented evidence that compliance with the reporting and filing requirements of the taxing authorities would be burdensome and expensive, and that a flat 25% deduction for United States taxes would exceed the amount of tax that would be deducted if official tax tables were

used on known exemptions and past income, the District Court concluded that petitioner should be required to withhold United States but not New York City payroll related taxes in making wage claim distributions even though the United States had failed to file a proof of claim for such taxes in the bankruptcy proceeding. The District Court also directed that such taxes as were withheld should be accorded fourth priority status under 11 U.S.C § 104(a)(4), and that no tax need be withheld for New York City taxes because New York City's tax law did not become effective until 1966, after the date on which the wage claims accrued.

On appeal to the United States Court of Appeals for the Second Circuit, the court affirmed in part and reversed in part holding that taxes should be withheld for New York City as well as United States taxes, and that such taxes as were withheld should be accorded second priority status under 11 U.S.C. § 104(a)(2).

Reasons for Granting the Writ

Certiorari should be granted because of the conflict among the circuits as to the priority to be accorded withholding taxes on pre-bankruptcy wage claims under the Bankruptcy Act. The Eighth and Ninth Circuits in *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947) and *Lines* v. *State of California,* 242 F.2d 20 (9th Cir. 1957), *rehearing denied,* 246 F.2d 70, *cert den.,* 355 U.S. 857, accorded such withheld taxes a first priority under 11 U.S.C. § 104(a)(1). The Third Circuit *In Re Connecticut Motor Lines,* 336 F.2d 96 (3rd Cir. 1964) accorded such withheld taxes a fourth priority under 11 U.S.C. § 104(a)(4). Finally, the Second Circuit in the case at bar accorded such taxes a second priority under 11 U.S.C. § 104(a)(2), reversing the lower court decision which accorded such taxes a fourth priority under 11 U.S.C. § 104(a)(4). Moreover, a conflict exists among the circuits as to the

necessity for the United States Government and presumably other taxing authorities to file proofs of claim in connection with such taxes. The Third Circuit in *In Re Connecticut Motor Lines, supra.*, in apparent reliance of the Eighth Circuit holding in *Fogarty, supra,* held that tax claims in connection with withheld taxes on wage claims are barred pursuant to 11 U.S.C. § 93(n) unless the taxing authority in question files a timely proof of claim in connection with such taxes; whereas the court below concluded that the claims could be allowed even if no proofs of claim were filed. Finally, a conflict exists as to whether withholding taxes must be deducted at all in connection with priority wage claim distributions. Most of the circuits, including the court below, have concluded that they are, but the district court in *In Re Erie Forge & Steel Corp.*, United States District Court, Western District of Pennsylvania, No. 69-83, December 29, 1962 (unreported), has concluded that they are not. In this connection, the court is referred to the decision in the court below which concedes that an argument could be made that a wage claim distribution may not be the same thing as wages subject to withholding taxes (p. 4077), and the holding of the Second Circuit in *In the Matter of Kokoska,* United States Court of Appeals, Second Circuit, No. 496, September Term, 1972 (unreported), that notwithstanding that wages are entitled to a priority status in a bankruptcy proceeding, that "just because some property interest had its source in wages, however, does not give it special protection, for to do so would exempt from the bankrupt estate most of the property owned by many bankrupts * * * which had their origin in wages" (p. 3674). In other words, the Second Circuit itself concedes that a difference exists between "wages" and "wage claims" and in the absence of a definitive determination that wage claims are the equivalent of wages, no determination can or should be made that taxes should be withheld at all on wage claim distributions.

The decision in the court below also creates anomaly in its attempt to distinguish this court's holding in *United States* v. *Randall,* 401 U.S. 513 (1971) from the case at bar. *Randall* held that where a wage claim has actually been paid the tax to be withheld on the wage claim distribution does not fall into the same priority status under the Bankruptcy Act as the wage claim itself; whereas the court below held that where the wage claim has not been paid, that it does. The anomaly is compounded by the provisions of 11 U.S.C. § 104(a)(4) which accords a fourth priority to taxes on wages actually paid prior to bankruptcy, whereas the holding of the court below accords second priority status to taxes on wages paid after bankruptcy. In this connection, the Seventh Circuit in *In Re John Horne Co.,* 220 F.2d 33 (7th Cir. 1955), relying somewhat on *Pomper* v. *United States,* 193 F.2d 211 (2d Cir. 1952), both dealing with wages actually paid before bankruptcy, held that the taxes relative to such wages should be accorded fourth priority status under 11 U.S.C. § 104(a)(4).

CONCLUSION

It is respectfully submitted that the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A—DECISION OF

United States Court of Appeals

FOR THE SECOND CIRCUIT

Nos. 427, 804, 805—September Term, 1972.

(Argued March 15, 1973 Decided June 8, 1973.)

Docket Nos. 72-1546, 72-1551, 72-1716

In re Freedomland, Inc.

Bankrupt

Before:

HAYS, MULLIGAN and OAKES,

Circuit Judges.

Appeal from a judgment in the Southern District of New York, Constance B. Motley, *Judge*, (1) ordering the bankruptcy trustee to withhold taxes and file necessary forms on wages earned but not paid prior to bankruptcy; (2) assigning the taxes a fourth priority as "taxes due and owing by the bankrupt," 11 U.S.C. § 104(a)(4); and (3) denying New York City's claim for withheld taxes on the ground that the City's income tax was passed after the date the wages were earned.

Affirmed in part, reversed and remanded in part.

HOWARD KARASIK, New York, New York *for Appellant Otte, Trustee in Bankruptcy of Freedomland, Inc.*

SUSAN FREIMAN, Assistant United States Attorney (Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, on the brief) *for Appellant United States.*

SAMUEL J. WARMS, New York, New York (Norman Redlich, Corporation Counsel for the City of New York, Raymond Herzog and Cornelius F. Roche, of counsel), *for Appellant New York City.*

OAKES, *Circuit Judge*:

This case presents the esoteric, but nevertheless highly practical, issue of how withholding on wages earned before bankruptcy is to be handled in bankruptcy. Involved are both the income tax laws, silent in this regard as to the effect of bankruptcy, and the bankruptcy laws, silent as to the status of moneys withheld and indeed inarticulate as to the category of priority within which *previously* earned wages fit. The problems presented in winding a tortuous path between two inexact sets of statutes in these two different areas of law as to withholdings claimed due the United States are further complicated by virtue of a claim for income tax withholdings by the City of New York on a statute enacted *after* the wages were earned but before any payments on their account to the wage earners have been made by the bankruptcy trustee.

Freedomland, Inc., filed an arrangement petition under Chapter XI of the Bankruptcy Act on September 15, 1964, and was adjudicated a bankrupt on August 30, 1965. During the statutory period for filing claims, 413 claims of $600 or less, totaling approximately $80,000, were filed by former employees of Freedomland on account of wages earned *before* the filing of the Chapter XI petition. 11

U.S.C. § 93. No claims for withholding, social security or related taxes were filed either by the United States or the City of New York during the statutory filing period or otherwise.[1] The trustee, on November 7, 1969, moved the referee for an order authorizing payment to the wage claimants without withholding income, social security or other taxes and an order specifically declaring that he was not required (1) to make any such payments to any governmental body; (2) to prepare, distribute or file wage and tax statements for the employees or as an employer; or (3) to pay any penalties. The referee, Edward J. Ryan, was apparently much taken with the criticism by a fellow referee of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), which held that a trustee must withhold income and social security taxes and that the taxes were payable as an administration expense entitled to first priority.[2] Referee Ryan accordingly on January 27, 1971, granted the trustee's petition on all counts, holding that "compliance with withholding and reporting requirements of tax authorities

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[1] The United States had filed a claim for federal income and social security taxes due on wages *actually paid* during the quarter immediately preceding the petition for an arrangement. No claim was filed for those due on *unpaid* wages during that quarter, however, and it is withholdings on those wages which are in dispute here.

[2] *See* Hiller, *The Folly of the Fogarty Case,* 32 J. of Nat'l Ass'n of Ref. 54 (1958).

In general terms § 64(a) of the Bankruptcy Act, 11 U.S.C. § 104, categorizes debts having priority in the following order:

1. costs and expenses of administration;
2. wages not exceeding $600 earned within three months before the date of the commencement of the proceeding;
3. creditor's expenses in setting aside confirmation of an arrangement or obtaining refusal of a discharge;
4. "taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof . . . ." and
5. debts owing to persons entitled to property by law.

is utterly inconsistent with the spirit and the letter of the Bankruptcy Act," particularly the policy in favor of "efficient, expeditious economic administration of bankrupt estates."

The district court took evidence on the question what administrative burdens were imposed by the requirement that taxes were to be withheld, paid over and duly accounted for by the bankruptcy trustee. The district court noted (as the referee had previously) a bankruptcy practice in the Southern District of New York, concurred in by IRS, of deducting 25 per cent of gross wage claims, covering both income and social security taxes, and paying it in one check to the Director of Internal Revenue without allocation to the various individual taxpayers. Further evidence indicated that a junior accountant or clerk with payroll records could make the 25 per cent calculations quite readily and could also fill out forms 941 and W-3 for the Government and forms W-2 for the individual employees respectively. On the basis of this evidence the district court, in an opinion printed at 341 F. Supp. 647 (S.D.N.Y. 1972), reversed the referee's order that the trustee was not required to withhold taxes or file the necessary forms. The court then went on to hold, relying upon *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), that withholdings were not "expenses of administration" as held in *United States* v. *Fogarty, supra,* but rather were entitled only to a fourth priority as taxes "legally due and owing" to the United States by the bankrupt. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4). In reaching this decision, the court also referred to *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), *cert. denied sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652 (1935), for the proposition that "before a tax could be found to be legally due and owing by the bankrupt . . . enough must have been known about the basis of the tax to make the tax computable or 'knowable' before bankruptcy, although not collectible until after ad-

judication." 341 F. Supp. at 656. As to the City of New York's claim, the district court held that since the City tax was not even enacted until 1966 [3] there were no taxes that could be said to be legally due and owing to it in September, 1964, when the Chapter XI proceeding was filed, and hence the City had no claim, under *In re International Match Corp., supra.* For the reasons which we state hereafter, we agree with the district court insofar as it required withholding and filing the prescribed forms, but disagree as to the order of priority assigned by it to withholdings, as well as to its treatment of the claim of the City of New York.

The first issue is whether a bankruptcy trustee must withhold under federal income tax law. The Internal Revenue Code of 1954, § 3401(a) defines "wages" as "all remuneration . . . for services performed by an employee for his employer. . . ." Were we to face this question afresh, an argument might be made that payments made by a bankruptcy trustee for wages earned before bankruptcy are really wage claim distributions. For example, as pointed out to us by the trustee, a solvent employer required to pay a judgment for disputed wages earned might not be paying "wages." *Cf.* Rev. Rul. 55-520, 1955 Int. Rev. Bull. No. 2 at 393-94 (compromise settlement for cancellation of employment contract not wages for withholding or FICA); Rev. Rul. 69-136, 1969 Int. Rev. Bull. No. 1 at 252-53 (sums paid former employees while in military service not wages). Further, it could be advanced that the bankruptcy trustee is not an "employer" since he has no "right to control and direct," 26 C.F.R. § 31.3401(c)-

[3] New York City has had since July 1, 1966, a tax on residents as well as nonresidents earning wages in New York that tracks the federal tax (with limited immaterial modifications), New York City Admin. Code § T46-11.0, 12.0, and contains appropriate withholding provisions. New York City Admin. Code, Ch. 46, Titles T (residents) and U (non-residents). The rate of the tax is agreed upon here as 1 per cent.

1(b), the "individual performing services," 26 C.F.R. § 31.3401(c)-1(a), that is, the wage claimant. *See In re Park Brewing Co.*, 49 F. Supp. 750 (W.D. Mich. 1942). *But see* Int. Rev. Code of 1954, § 3401(d)(1) (defining "employer" as "the person having control of the *payment* of . . . wages . . . ." [emphasis supplied]);[4] *Educational Fund of the Electrical Industry* v. *United States*, 426 F.2d 1053 (2d Cir. 1970) (payments to union members attending school which under collective bargaining agreement derived from employers but were paid out by union trust denominated as "educational fund" constituted "wages" for withholding, and educational fund held to constitute "employer" under § 3401(d)(1)).

We are not writing on a clean slate, however. *United States* v. *Fogarty, supra,* decided in the Eighth Circuit has been followed first in the Sixth, *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950), and then in the Ninth Circuits on this point. *Lines* v. *State Department of Employment,* 242 F.2d 201 (9th Cir.), *rehearing denied with opinion,* 246 F.2d 70, *cert. denied,* 355 U.S. 857 (1957). *See also In re Connecticut Motor Lines, Inc.*, 217 F. Supp. 330 (E.D. Pa.), *supplemented* 223 F. Supp. 189 (1963), *rev'd on other grounds,* 336 F.2d 96 (3rd Cir. 1964). While *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field,[5] there is no decision of any court outstanding to the contrary on the point of necessity of withholding.

Indeed, as was found below, until it was decided to make a test case of this one—and we are appalled that

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[4] The trustee suggests that he does not have "control" because payment requires an order of the court and the referee's countersignature. But the trustee applies for the order and has title to the funds to be paid, and when he sends the checks out he surely has "control of the payment."

[5] 3A Collier on Bankruptcy ¶ 64.202 at 2119 n.1 (14th ed. 1972); Hiller, supra note 2.

almost nine years elapsed from the time the wages were earned until the case came to us [6]—the bankruptcy trustees, at least in the Southern District of New York, managed perfectly well with the rough deduction of 25 per cent and remittance of that sum to the Director. The trustee's and referee's parade of horribles relating to computations, employment of accountants, completion of forms, etc., was quite deflated by the court below in its findings,[7] and especially its conclusion that "Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment." 341 F. Supp. at 654. The result in Fogarty at least has the virtue that wage earners themselves do not have the job of determining their individual FICA taxes or figuring how to report them so as to obtain full social security credit therefor.

It may be that a dust cloth will be needed to wipe the cobwebs away from the files in which the wage and payroll records for the quarter in question are stored, now that so much time has gone by, but the amount of effort required on the trustee's part in a bankruptcy matter involving the sums that this one does is relatively small, even though 413 wage claimants are involved. That effort prob-

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[6] In this connection it might be noted that even the referee whose criticism of *Fogarty* was heavily relied on by the referee here refused to create a test case challenging the *Fogarty* rule in his circuit because he realized the "hardship that a protracted delay would entail" to the needy coal miners involved in his case. Hiller, *supra* note 2, at 54.

[7] The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee of the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office. 341 F. Supp. 647, 653.

ably doesn't begin to match that which will be required of a conscientious trustee to track down the present addresses of the former employees so that they may receive their long overdue wages in the mail, effort which could largely have been avoided had distributions been made when they first could have been, several years ago. We thus hold that the trustee, as a person who substantially controls the payment of wages, Int. Rev. Code of 1954, § 3401(d)(1), is an employer for withholding tax purposes and must withhold.

It follows that as employer the trustee must file the requisite forms, including 941, W-2 and W-3, as he was ordered to do below. *Cf. Nicholas* v. *United States*, 384 U.S. 678, 692-93 (1966) (trustee in bankruptcy held under an Int. Rev. Code of 1954, § 6011(a) obligation to file returns for taxes incurred by debtor in possession). We hold also that he may withhold on the 25 per cent basis which the court below found, with no real dispute here, represents an IRS attempt to facilitate bankruptcy administration on quite a practical basis. We see no objection to this commonsense approach, for if there is an overpayment the employee can file for a refund. Of course, as income or social security taxes change—and the latter have increased .65 per cent from 1971 to 1973—the 25 per cent may have to be adjusted slightly.[8] Perhaps Congress will

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[8] It should be remembered that these wage earners are in the highest degree of likelihood on the cash basis, Int. Rev. Code of 1954, § 446(a) & (c), so that the rates of tax in effect in the year of *payment* as opposed to the year of wage-earning or the year of the referee's order permitting payment govern. *Muhleman* v. *Hoey*, 124 F.2d 414, 415 (2d Cir. 1942); 2 Mertens, The Law of Federal Income Taxation § 12.42 at 179 (1973):

> The doctrine that payments of compensation are income to a taxpayer on a cash basis in the year of receipt, as distinguished from the year in which the compensation is earned, is too firmly embedded in the income tax law to permit of any question.
>
> Withholding of social security taxes is also done "by deducting the amount of the tax from the wages *as and when paid.*" Int. Rev. Code of 1954, § 3102(a) (emphasis supplied).

ultimately be of assistance here. But in any event the 25 per cent figure still seems a sound one and one easy to compute.

To which, if any, of the five priorities under § 64 of the Bankruptcy Act, note 2 *supra*, then, are withholdings on wage distributions to be assigned? The *Fogarty* case held that they should be classified as administration expenses, that is, in the first priority. *See also Lines* v. *State Department of Employment, supra.* But "the costs and expenses of administration," § 64(a)(1) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1), must in general relate to the preservation or development of the bankrupt's assets. *See, e.g., Adair* v. *Bank of America National Trust & Savings Association,* 303 U.S. 350, 361 (1938). We agree that the Third Circuit's criticism of *Fogarty* and *Lines* in *In re Connecticut Motor Lines, Inc., supra,* 336 F.2d at 99-102, *noted,* 63 Mich. L. Rev. 1103 (1965), 40 N.Y.U.L. Rev. 360 (1965), 19 Rutgers L. Rev. 546 (1965). *See also Denton & Anderson Co.* v. *Induction Heating Corp.,* 178 F.2d 841, 843-44 (2d Cir. 1949) (commissions accruing after bankruptcy on goods ordered but not filled prior thereto held *not* entitled to first priority status). By according (a)(1) status to withholding taxes they would take priority over the wages on which they were based. In *Lines,* indeed, dividends which would have gone to wage earners were depleted by an employer's tax payment to the unemployment insurance fund. *See* 56 Mich. L. Rev. 631, 633 (1958).

We do not agree, however, with the Third Circuit's treatment in *Connecticut Motor Lines* of withholdings as "taxes which became legally due and owing *by the bankrupt*" (emphasis supplied), and hence entitled to fourth priority treatment. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4).[9] The taxes are by law calculable only when the

[9] The Seventh Circuit reached the same result *In re John Horne Co.,* 220 F.2d 33 (7th Cir. 1955), relying somewhat on our own *Pomper* v. *United States,* 196 F.2d 211 (2d Cir. 1952). Both *Horne* and *Pomper,* however, dealt with wages actually paid before bankruptcy, not the case here. *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950).

wage claims are paid and not until then, note 7 *supra*, regardless of any practice by IRS to accept a flat payment of a specified percentage such as 25 per cent. The taxes were never "due and owing by the bankrupt," which was Freedomland.[10] When a tax "cannot be computed as of the date of the petition in bankruptcy," it is not "due and owing by the bankrupt." *In re International Match Corp., supra.*

We agree, rather, with the very persuasive brief of the City of New York that the proper classification for the withholdings to be made is that of second priority wage claims. All of the withholding taxes, whether federal or city, derive from the payments which will be made to the wage claimants. Int. Rev. Code of 1954, §§ 3402, 3101; New York City Admin. Code § T46-51.0 and § U46-8.0. The claimants are credited with the withheld amounts toward their income taxes. Int. Rev. Code of 1954, § 31(a); New York City Admin. Code § T46-53.0 and § 46-10.0. Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part. *Cf. In re Quakertown Shopping Center, Inc.*, 366 F.2d 95 (3rd Cir. 1966) (IRS can levy upon the claim of a taxpayer-creditor against a bankrupt estate without approval of bankruptcy court).

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[10] It is for this reason we reject the argument made by the Third Circuit, *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102-06 (3rd Cir. 1964), relied on by the district court here, 341 F. Supp. at 656-57, that a concerted legislative policy to reduce the priority of tax claims in bankruptcy requires a fourth priority classification for the withheld taxes here. The legislative policy discerned relates to taxes owed by the bankrupt, not by the bankrupt's employees. The fourth priority in bankruptcy relates historically and otherwise to taxes owed by the bankrupt. Similarly, the 64(a)(2) priority derives from 132 years of statutory history relating to the status of wage claims in bankruptcy, a history long precedent to the adoption in 1943 of what some will recall as "pay-as-you-go." Act of June 9, 1943, c.120 § 2(a), 57 Stat. 126, Int. Rev. Code of 1939, § 1621, as amended.

In our view when wage claims are ordered to be paid by the bankruptcy court they should be segregated and the tax monies due held as trust funds. Int. Rev. Code of 1954, § 7501(a); New York City Admin. Code § T46-55.0 and § U46-12.0. It is true that *United States* v. *Randall*, 401 U.S. 513 (1971) (5-4 decision), held that where a debtor in possession failed to obey an order of the bankruptcy court to deposit withheld taxes in a special tax account, the Bankruptcy Act's (a)(1) priority for costs and expenses of administration would override any claim pursuant to 26 U.S.C. § 7501(a) that the withheld taxes "shall be held to be a special fund in trust for the United States." *But cf. In re Airline-Arista Printing Corp.*, 267 F.2d 333 (2d Cir. 1959), and *City of New York* v. *Rassner*, 127 F.2d 703 (2d Cir. 1942), referred to in *United States* v. *Randall, supra*, 401 U.S. at 519 (dissenting opinion). *Randall*, however, did not reach the question before us. Rather, it was concerned only with vindicating the Bankruptcy Act's "policy of subordinating taxes to costs and expenses of administration." 401 U.S. at 517. That policy is fully upheld by placing the withheld taxes here in a second priority position along with the wages that create them. In other words, the trust which arises is subject to the prior payment of the statute-specified costs and expenses of administration, but exists nevertheless as to withholdings on wage claims allowed.[11] In this view, contrary to the view of the Third Circuit in *Connecticut Motor Lines, supra*, 336 F.2d at 107, there is no necessity for the Government (or City) to file proofs of claims for withholdings. Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt*, not the case here. The

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[11] The second sentence of § 7501 of the Int. Rev. Code of 1954 is consistent with this view:

> . . . The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. In this respect we agree with the court below.

There remains for consideration only the question whether New York City may obtain withholding taxes on the wage claims paid since there was not even a city income tax in effect when the wages were earned. But we have already pointed out that the wage earners here are in all probability on the cash basis, note 7 *supra,* so that regardless of when the wages were earned, they are income and taxable in the year received. As we have already said, liability for withholding arises when the wage claims are paid. Int. Rev. Code of 1954, §§ 3402, 3101 and 31(a). The City in this respect is in the same position as the federal government. New York City Admin. Code §§ T46-51.0 and U46-8.0; §§ T46-53.0 and U46-10.0. Wages are just as much a part of city "adjusted gross income," New York City Admin. Code § T46-12.0, as they are of federal. The fact that the city tax applies to wages earned before its effective date is not important since no vested rights are impaired. *See Welch* v. *Henry,* 305 U.S. 134, 146-51 (1938); *Milliken* v. *United States,* 283 U.S. 15, 20-24 (1931); *Kentucky Union Co.* v. *Kentucky,* 219 U.S. 140, 152-53 (1911) ("Laws of a retroactive nature, imposing taxes . . . and not impairing vested rights, are not forbidden by the Federal Constitution"). *See also Lynch* v. *Hornby,* 247 U.S. 339 (1918) (federal income tax law constitutionally permits taxation of dividends paid out of surplus accumulated before date of act); *Neild* v. *District of Columbia,* 110 F.2d 246, 253 (D.C. Cir. 1940). We conclude that the City is as entitled to its withholding tax as the federal government is to its taxes.

We add only that to the extent there is now a conflict among the circuits as to priorities of withholding taxes on

pre-bankruptcy wages earned—the Eighth and Ninth Circuits going for the first, the Third for the fourth and the Second for the second—correction may come either from Congress or the High Court. It is a pity that the wage claimants here had to wait so long for the case to wend its way to our court, and that so many of them were involved. Nevertheless the question has some significance in the administration of bankrupt estates so that it is perhaps well that after the 25 years that have elapsed since *Forgarty* the matter might receive some further congressional or judicial attention.

We reverse and remand for the entry of judgment in accordance with this opinion.

APPENDIX B

Title 11, United States Code:

§ 93. Proof and allowance of Claims

(j) Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

(n) Except as otherwise provided in this title, all claims provable under this title, including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed.

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon (8) contingent debts and contingent contractual liabilities;

§ 104. Debts which have priority

(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit

of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of Title 18, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this title directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by section 638, 778, or 883 of this title, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include

all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 107 of this title: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

Title 26, United States Code:

§ 3102. Deduction of tax from wages

(a) Requirement.—The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by de-

ducting the amount of the tax from the wages as and when paid. An employer who in any calendar quarter pays to an employee cash remuneration to which paragraph (7) (B) or (C) or (10) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar quarter is less than $50:

§ 3401. Definitions

(a) Wages.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

(d) Employer.—For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

> (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

§ 6001. Notice or regulations requiring records, statements, and special returns

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such per-

son or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 6011. General requirement of return, statement, or list

(a) General rule.—When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

§ 6041. Information at source

(a) Payments of $600 or more.—All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments to which section 6042(a) (1), 6044(a) (1), or 6049(a) (1) applies, and other than payments with respect to which a statement is required under the authority of section 6042(a) (2), 6044(a) (2), 6045, 6049(a) (2), or 6049 (a) (3)), of $600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary or his delegate, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary or his delegate, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.